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June 7, 1996

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Federal Communications Commission
Office of Secretary

Ex Parte

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

DOCKET FILE COPY ORIGINAL

Re: CC Docket No. 96-98, Implementation of the Local Competition Provisions in the Telecommunications Act of 1996

Dear Mr. Caton:

Please be advised that the attached information is being sent to Joseph Farrell, Chief Economist and James Schlichting, Chief of the Competitive Pricing Division, at their direct request. Please associate these materials with the above-referenced proceeding.

If you should have any questions regarding this subject matter, please contact me.

Sincerely,

Sandra L. Wagner

Attachment

cc: Joseph Farrell
James Schlichting

No. of Copies rec'd 0+3
List ABCDE

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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| AT&T COMMUNICATIONS OF ILLINOIS, INC.<br><br>Petition for a Total Local Exchange Wholesale Service Tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act. | ) | 95-0458 |
| LDDS COMMUNICATIONS, INC., d/b/a LDDS METROMEDIA COMMUNICATIONS<br><br>Petition for a Total Wholesale Network Service Tariff from Illinois Bell Telephone Company d/b/a Ameritech Illinois and Central Telephone Company Pursuant to Section 13-505.5 of the Illinois Public Utilities Act. | ) | 95-0531<br>(Consolidated) |

**EXCEPTIONS OF MFS INTELENET OF ILLINOIS, INC.**
**<u>TO THE HEARING EXAMINER'S PROPOSED ORDER</u>**

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Dated: May 24, 1996

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ILLINOIS COMMERCE COMMISSION

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**EXCEPTIONS OF MFS INTELENET OF ILLINOIS, INC.**
**TO THE HEARING EXAMINER'S PROPOSED ORDER**

MFS Intelenet of Illinois, Inc. ("MFS-II"), by its undersigned counsel, respectfully submits its Exceptions to the Hearing Examiner's Proposed Order ("HEPO") in the above-captioned consolidated proceedings. In support of its Exceptions, MFS-II states as follows:

## INTRODUCTION

While the Hearing Examiner obviously has done a thorough job of sifting through an enormous number of complex issues of policy and statutory interpretation, the overall thrust of the HEPO is not consistent with the Telecommunications Act of 1996, Pub. L. 104-104, 110 Stat. 56 ("1996 Act"). Even more importantly, the HEPO would lead to unfortunate results for the telecommunications consumers of Illinois, in that it would provide undue incentives for entrants to utilize all of the incumbent's facilities, rather than deploying any of their own facilities. This would deprive Illinois consumers of the benefits that come from competitive deployment of different facilities. Because entrants would be using the incumbent's facilities, rather than provisioning their own, there would be no prospect that they could pare down inefficiencies in the provision of facilities.

MFS-II submits four Exceptions. First, MFS-II contests the Hearing Examiner's treatment of contribution as an "avoided cost" that is to be subtracted from the retail rate in calculating wholesale rates. By definition, contribution is simply not a cost that is "avoided" by an incumbent local exchange carrier ("LEC") when it sells at wholesale, rather than at retail.

Second, MFS-II argues that facilities-based entrants should not have to share in the start-up costs of implementing resale. Facilities-based entry will generate its own start-up costs. Resellers are not required to share in the start-up costs of facilities-based entry, and facilities-based entrants should not be required to share in the start-up costs of resale.

Third, MFS-II challenges the Hearing Examiner's requirement that incumbents be forced to offer for resale bundled service from which operator service and directory assistance have been stripped out or "unbundled." This requirement confuses the resale provisions with the unbundling provisions of the 1996 Act. The resale provisions only require the resale of a service that is offered to end users who are not carriers. This stripped service is not such a service.

Fourth, MFS-II excepts from the Hearing Examiner's grant of LDDS's Petition. While the HEPO grants that Petition as though it were a petition for unbundling, the Petition is, in its own words, a petition for "resale" of "bundled" service, and invokes the Illinois resale statute, not the unbundling statute. Moreover, although LDDS's Petition plainly seeks to use the incumbent LEC's entire network, and to provide none of the entrant's own facilities, the pricing methodology adopted by the HEPO is more favorable than the resale pricing methodology provided by the 1996 Act. If adopted, the HEPO would render nugatory the resale pricing methodology of the 1996 Act.

## EXCEPTIONS

### I. THE COMMISSION SHOULD REJECT THE HEARING EXAMINER'S RECOMMENDATION THAT CONTRIBUTION BE TREATED AS AN AVOIDED COST

In the HEPO, the Hearing Examiner recommends that contribution be treated as an avoided cost in determining the pricing standard and cost basis for wholesale services. *See* HEPO at 5-20. He prefaces his recommendation by stating that "[m]ore than any other issue in this proceeding, our Commission's decisions with respect to the pricing of wholesale service will have profound effects on the local exchange market." *Id.* at 5. He further states that "[t]he Commission's interpretation of Section 252(d)(3) of the federal Act is the single most important issue before the Commission in this docket." *Id.* at 6. Finally, he warns that setting wholesale prices either too high or too low may discourage competitors from entering the local exchange market, and that setting wholesale prices too low would, additionally, "have a negative impact on the amount of investment made by the incumbent LECs in their underlying local network." *Id.* at 5.

The Hearing Examiner then reviews the language and purpose of the 1996 Act and concludes that Section 252(d)(3) "allows this Commission the discretion to set a wholesale price in a manner that places some competitive pressure on the incumbent LECs as local competition increases, thereby creating effective competition." *Id.* at 17. He rejects the various pricing methodologies proposed by Ameritech, AT&T and others because they purportedly discourage entry by either facilities-based competitors or pure resellers and recommends that the Commission adopt, with several modifications. the pricing methodology proposed by the Commission Staff ("Staff"). *Id.* at 17-20.

As a result of his analysis, the Hearing Examiner proposes setting a wholesale price by taking the retail price less net total assigned cost of retail functions less a pro rata share of contribution attributable to the avoided retail costs. *Id.* at 8. For Ameritech, this results in a 22% discount for resellers. *Id.* at 13. In this context, contribution refers to an apportionment of revenues to joint and common costs. Joint costs are costs of a service that occur in the production of two or more services; common costs are costs which are common to a carrier that are not directly attributable to any particular service. *Id.* at 8-9.

MFS-II takes exception to this recommendation. As shown below, treating contribution as an avoided cost in determining the cost basis for wholesale services ignores the clear language of Section 252(d)(3) of the 1996 Act and is at odds with its intent and underlying policies.

### A. Section 252(d)(3) of the 1996 Act Does Not Permit the Treatment of Contribution As An Avoided Cost

As an initial matter, the Hearing Officer's recommendation to adopt, with some modifications, Staff's proposed methodology for setting wholesale prices must be rejected because it runs counter to the express language of the 1996 Act. Section 252(d)(3) of the Act provides, in pertinent part, that:

> a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.

1996 Act, §252(d)(3). Under the 1996 Act, the cost "that will be avoided" is, quite simply, the difference between the total cost incurred to provide the service on a retail basis and the total cost incurred to provide it on a wholesale basis.

The Commission should reject the Hearing Officer's recommendation that avoided costs include some share of joint and common costs. General overhead consists of joint and common costs that are attributable to more than one service and, in the interest of efficiency, are recovered from all of these services. These costs will continue to be incurred whether the incumbent LEC provides its services on a wholesale or on a retail basis. Indeed, by definition, costs that are avoided when the incumbent LEC ceases to provide a particular service are direct costs of that service, *not* joint or common costs. Since, as a factual matter, joint and common costs will not be avoided when the incumbent LEC provides services on a wholesale (rather than a retail) basis, those costs cannot be removed from wholesale rates under the pricing standard of Subsection 252(d)(3). When Congress created a discount for "any marketing, billing, collection and other costs that *will be avoided*," it clearly intended *not* to create a discount for costs that *will not be avoided*. The Commission has no legal basis to disregard the plain text of the 1996 Act.

### B. The Legislative History of § 252(d)(3) of the 1996 Act Indicates that Congress Did Not Consider Contribution to Be an Avoided Cost

The legislative history of § 252(d)(3) of the 1996 Act evidences Congress's desire to preserve contribution in the wholesale rates for incumbent LECs' retail services. In committee in the House of Representatives, H.R. 1555 originally required resale rates to be "economically feasible" to the reseller.[1] In other words, resale rates would have to provide some amount of profit for resellers. Gradually, committee members realized that forcing incumbent LECs to sell their retail services at wholesale, without contribution, would cause "local rates to skyrocket for the household user."[2] Before H.R. 1555 went to conference, the committee replaced the "economically feasible" language with an avoided costs formula[3] that was included in the version of H.R. 1555 passed by the House.[4] The conference committee incorporated the resale language of H.R.1555, in substantially the same form, into the 1996 Act as § 252(d)(3).

In the Senate committee that heard S.652, similar concerns about the potential negative effects of excluding contribution from wholesale rates arose. The Senate committee was less organized than its counterpart in the House. The final version of S.652 passed by the Senate did not address resale. But an amendment proposed in committee — that would have based resale prices on cost, with contribution "counted towards the recovery of costs in setting resale prices" — was withdrawn on the understanding that the conference committee would resolve the issue.[5]

Without a doubt, Congress already has weighed and decided the issue of whether contribution should be considered an avoided cost under § 252(d)(3). It deliberately selected the tops down resale pricing methodology in an effort to preserve contribution in wholesale rates. The

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1/ H.R. 1555, as reported by the Subcommittee on Telecommunications and Finance (Committee Print) (May 20, 1995), § 242(a)(3).

2/ 141 Cong. Rec. H8452 (1995).

3/ Bliley Amendment, proposed August 4, 1995, 141 Cong. Rec. H8444 (1995).

4/ H.R. 1555, § 242(a)(2) and (3), as passed by the House in August, 1995.

5/ 141 Cong. Rec. S8369, S8400, S8438 (1995).

Commission cannot find contribution to be an avoided cost without directly contravening the will of Congress.

### C. To The Extent The 1996 Act Provides Any Discretion In Determining Avoided Costs, The Issue Should First Be Addressed By The Federal Communications Commission In Its Pending Rulemaking

On April 19, 1996, the Federal Communications Commission released a *Notice of Proposed Rulemaking*, announcing its intent "to devise a new national policy framework — a new regulatory paradigm for telecommunications — which accommodates and accelerates technological change and innovation" and which achieves Congress's policy goals of advancing competition, reducing regulation in telecommunications markets, and advancing and preserving universal service nationwide.[6] The FCC is currently seeking comments from the public and interested parties and has announced its intention to issue a proposed rule by August 8, 1996.

Included among the issues that the FCC has indicated it will consider is the issue of whether avoided costs should include joint and common costs. *Id.* at ¶ 180 ("We seek comment on whether avoided costs should also include a share of general overhead or 'mark-up' assigned to such costs.") Indeed, the FCC is specifically seeking comments on Staff's recommendation that wholesale prices be set on the basis of retail rates less a measure of net avoided costs. *Id.* at ¶ 183.

In light of the FCC's express intent to address the issue of contribution in its proposed rulemaking, this Commission should defer consideration of that issue. Deferral would enable the

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[6] *In the Matter of Implementation of the Local Competition Provisions of the Telecommunications Act of 1996,* Notice of Proposed Rulemaking, CC Docket No. 96-98 (released April 19, 1996), at 3 ("*NPRM*").

Commission to benefit from the FCC's consideration and would allow a uniform, nationwide application of Section 252 of the 1996 Act.

### D. Even If the Telecommunications Act of 1996 Provides This Commission With Some Discretion To Determine What Costs Are Avoided, The Commission Should Not Adopt The Hearing Examiner's Recommendation Because It Runs Counter To The Intent And Purposes Of The 1996 Act

In support of his recommendation that the Commission treat contribution as an avoided cost when setting the price of wholesale services, the Hearing Examiner concludes that Section 252(d)(3) of the 1996 Act gives the Commission the discretion to set a wholesale price that "would place competitive pressure on both the incumbent LECs, as well as the new entrants into the local exchange market." HEPO at 5. He acknowledges that "if the wholesale price is set artificially high, then competitors may be discouraged from entering the local exchange market, even if they could provide retail components more efficiently than the incumbent LEC." *Id.* He further acknowledges that "[c]onversely, if the wholesale price is set artificially low, then competitors would be discouraged from becoming facilities-based competitors, even if they could provide facilities-based services more efficiently than the incumbent LEC." *Id.* Unfortunately, as shown below, the Hearing Examiner's recommendation has tipped the scales in favor of the resellers and against the facilities-based providers.

There is little dispute that the size of the wholesale discount will determine whether entry occurs by resale or by facilities-based competition. As the Staff has observed, "the price set for wholesale local exchange services will dictate whether competitors choose to enter the local exchange market via resale or by becoming a facilities-based carrier"; if resellers are granted an excessive discount, even facilities-based competitors that would potentially be more efficient than the incumbent LEC would have to become resellers to survive in the local exchange market. ICC Staff 1.00 (Jennings) at 17-18. Staff agrees that if this were to occur, society would suffer because facilities would not be provided in the most efficient manner possible. *Id.* at 18. Indeed, as Staff witness Jennings testified, "If the wholesale price is too low, the Commission would, in effect, be subsidizing resale competition and would be discouraging facilities-based competition." *Id.* at 31. By treating contribution as an avoided cost, the Staff approach, endorsed by the Hearing Examiner, would in effect give resellers an additional 10 percentage points of margin for "free," without any corresponding increase in the operating or financial risks which they assume. This would encourage inefficient resale entry and unduly bias an entrant toward resale and away from facilities-based entry.

The California Public Utilities Commission found that large resale discounts would have an adverse impact on facilities development, concluding that:

> wholesale rates should be set high enough that LECs are fairly compensated. Otherwise, this would give resellers an unfair competitive advantage relative to the LECs as well as facilities-based CLCs [competitive local carriers]. *Order Instituting Rulemaking on the Commission's Own Motion into Competition for Local Exchange Service,* Decision 96-03-020, at 21 (California PUC Mar. 13, 1996).
>
> if the adjustment for avoided retail costs is too large, the LECs will not be compensated for their true costs. Moreover, facilities-based CLCs could be placed at a competitive disadvantage in pricing their retail service if CLC resellers are able to purchase wholesale local exchange service below its cost. *Id.* at 29.
>
> Our approach addresses concerns raised by Sprint, TCG, TW, CCTA and MFS that setting LEC resale rates at large wholesale discounts below actual costs would give CLC resellers an unfair advantage and discourage investment by facilities-based CLCs. Our reformulation of the AT&T/MCI model reduces the margin between wholesale and retail to better reflect avoided retailing costs which should help to spur development of competing networks. *Id.* at 32.

If wholesale discounts were too high, not only would there be no facilities-based competition, there would be no new investment in the local network. Ameritech Ex. 1.0 (Gebhardt) at 71-72; Ameritech Ex. 2.0 (Kraemer) at 22, 28-29; TC Systems Ex. 2 (Teske) at 10; Cellular One Ex. 1.0 (Ershen) at 6; Cellular One Ex. 2.0 (Ershen) at 5-6. The resale strategy would afford the richer, better-known competitors a steady stream of low-risk income and a substantial share of the market. Cellular One Ex. 1.0 (Ershen) at 6. They would have no reason to purchase their own facilities.[7] Ameritech Ex. 2.0 (Kraemer) at 22-25. In the long run, Illinois could encounter serious problems with the quality and longevity of its network because neither incumbent LECs nor new entrants would expend the capital necessary to keep the network technologically abreast:

> If the wholesale price of local exchange service is too low, facilities-based investment (including investment in new local exchange service technologies such as wireless and cable telephony) will be discouraged, and the beneficial effects of technological change on the development of efficient competition will be severely curtailed.

Ameritech Ex. 3.2 (Harris) at 26-27; *see* Cellular One Ex. 2.0 (Ershen) at 7. Consumers may also notice the scope of offered services stagnating as a result of the failure of market participants to add value to retail service offerings. Cellular One Ex. 2.0 (Ershen) at 7.

The 1996 Act clearly expresses a preference for facilities-based competition. In describing the necessary local competitive conditions for a Bell Operating Company, such as Ameritech

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[7] Normally, "[c]arriers invest in facilities precisely because of the competitive advantages which end-to-end service offers, from a marketing, provisioning and price perspective." Ameritech Ex. 1.0 (Gebhardt) at 23-24. It is, however, more difficult for a carrier to profit from the natural advantages of owning facilities when resale competitors are subsidized through regulatory pricing structures. Even AT&T witness Fonteix conceded that offering an excessive discount to carriers reselling business service "would irreparably distort competition by . . . discouraging or even pre-empting further facilities build-out to those very customers where the only measurable level of ompetitive facilities build-out is currently occurring." AT&T Ex. 1.0 (Fonteix) at 22.

Illinois, to offer interLATA services in its territory, the 1996 Act requires the presence of an exclusively or predominantly *facilities-based* competitor. 1996 Act, § 271(c)(1)(A). Undeniably, Congress did not consider resale competition sufficient to constitute a competitive local telecommunications environment. Rather, it emphasized the need for *facilities-based* competition. For example, Representative Goodlatte, in supporting the House bill, stated that

> [i]t gives new entrants the incentive to build their own local facilities-based networks rather than simply repackaging them and reselling the local services of the local telephone company. This is important if the information superhighway is to be truly competitive.

141 Cong. Rec. H.8465 (1995). Congress preferred the myriad benefits offered by facilities-based competitors to the limited benefits offered by resellers.

In support of his recommendation that contribution be treated as an avoided cost, the Hearing Examiner argues that avoided costs must include some contribution because, without contribution, the incumbent LEC "will not suffer a loss of profits as it loses market share to resellers." HEPO at 17. Without loss of profit from loss of market share, he reasons, the LEC would not feel any competitive pressure, a result which runs contrary to the 1996 Act.

This reasoning fails to consider that, even if contribution is not treated as an avoided cost, the incumbent LEC will feel pressure from several fronts as local competition increases. First and foremost, the incumbent LEC will feel pressure from the facilities-based competitors, who are best situated to exert competitive pressure on any incumbent LEC. Congress has confirmed that facilities-based entrants provide competition that simply cannot be realized through pure resale competition. This competition stems, in part, from the fact that partially or fully facilities-based carriers depend much less upon other carriers to supply the underlying network service than resellers.

As a result, the cost structure of a facilities-based entrant is largely independent of Ameritech's cost structure, thereby offering the prospect of more efficient production of service and enabling the entrant to bring additional price pressure to bear upon Ameritech.[8]

Second, even if contribution is not treated as an avoided cost, an incumbent LEC will also feel pressure from pure resellers. For example, if AT&T, through resale, obtains a base of customers who previously subscribed to Ameritech, AT&T will be in a position to convert those customers to use of its own facilities. Indeed, AT&T has acknowledged this strategy. *See* AT&T Ex. 1.0 (Fonteix) at 5-6. This threat places substantial pressure on Ameritech to avoid losing customers to resellers.

The Hearing Examiner also argues that treating contribution as an avoided cost will further the legislative "compromise" that Congress struck when it enacted the 1996 Act. HEPO at 17. According to the Hearing Examiner, this compromise imposes competition on incumbent LECs, which will cause them to lose some local market share and profits, in return for the opportunity to gain market share and profits in the long distance arena. *Id.* However, this interpretation of the 1996 Act overlooks the fact that Congress imposed the same requirement on all LECs, regardless of

[8] Pure resellers, on the other hand, merely buy the service they sell in toto from the LEC and re-label it. Tr. (Jennings) at 436; tr. (Ankum) at 468, 474-476; *see* TC Systems Ex. 1 (Teske) at 10 (switchless resale "does not involve any change in the technical characteristics of the local exchange service, and is more properly looked at simply as a difference in billing"). They cannot place pressure upon the incumbent LEC to reduce costs, other than retailing costs, because the LEC is their sole source of the underlying network service; thus, the incumbent is able to pass any inefficiencies in its own cost structure on to resellers. MFS Cross Ex. 1 at 61; Ameritech Ex. 1.0 (Gebhardt) at 23-24 ("resellers by definition are dependent on the pricing decisions of the underlying carrier for the margins available to them.") As the United States Department of Justice has observed, resale "brings competition only to the *marketing* of local exchange services." MFS Cross Ex. 4 at 19 (emphasis in original).

whether or not they are RBOCs. LECs that are not ROBCs, such as Centel, were free to offer long distance service before the 1996 Act. Thus, the Hearing Examiner's view of the 1996 Act as requiring incumbent LECs to lose contribution in exchange for entering long-distance is ill-founded.

Moreover, even if one were to accept the premise of the Hearing Examiner's "compromise" theory that incumbent LECs must lose local market share and profits as a *quid pro quo* for gaining interLATA market share and profits, the theory does not dictate that the losses in local market share and profits come at the hands of resellers. It is completely consistent with the Hearing Examiner's "compromise" theory that the incumbents' local losses come at the hands of facilities-based entrants. Indeed, there is no basis in the record to conclude that the Hearing Examiner's interpretation of the Act will result in more local losses for incumbents than the interpretation advocated by MFS-II. Even with the 22% discount set forth in the HEPO, Ameritech will continue to earn substantial contribution on sales to resellers. By contrast, if Ameritech loses a customer to a fully facilities-based entrant, the contribution it receives from that customer will drop to zero. It may well be that the Hearing Examiner's interpretation will dampen facilities-based entry to such a degree that it would preserve *more* of Ameritech's profits than MFS-II's interpretation.

Finally, as a policy matter, it would be inequitable to permit resellers and their end users to provide less contribution towards the Ameritech network than Ameritech receives from its own end users. Resellers and their end users benefit from Ameritech's network (the costs of which are recovered in contribution) to the same degree as Ameritech's end users. They should therefore pay the same amount to support the network. Moreover, since no fixed percentage mark-up was used to establish retail rates in the first place, there is no logical basis for pro-rating that mark-up when wholesale services are introduced. Ameritech Ex. 1.25 (Gebhardt) at 24.

In short, the Hearing Examiner's attempt to level the playing field for all competitors has resulted in a field that is tilted toward pure resellers and against facilities-based entrants. This result is contrary to the intent and purposes of the 1996 Act and, ultimately, will adversely affect local exchange competition in the State of Illinois.

Accordingly, paragraph 4 on page 16, pages 17 though 19, and paragraphs 1 through 5 on page 20 of the HEPO should be modified as follows:[9]

<u>The Commission cannot adopt Staff's proposed methodology because it contravenes the express language of the 1996 Act. Section 252(d)(3) of the 1996 Act expressly provides that "a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested excluding the portion thereof attributable to any marketing, billing, collection and other costs that will be avoided by the local exchange carrier." Incumbent LECs, such as Ameritech, will continue to incur general overhead costs and joint and common costs attributable to more than one service provider, regardless of how the incumbent LEC provides service. Since these costs will not be avoided, they cannot be removed from wholesale rates under the pricing standard contained in section 252(d)(3).</u>

<u>The legislative history of section 252(d)(3) of the 1996 Act demonstrates Congress's intent to preserve contribution in the wholesales rates for incumbent LECs' retail services. During consideration of both the Senate and House versions of the telecommunications bill, members of both houses deliberately rejected the notion that LECs should be denied contribution.</u>

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[9] For all language proposed by MFS-II, the following conventions apply: normal text represents the Hearing Examiner's writing that should be retained; text that has been struck through indicates text of the Hearing Examiner that MFS-II rejects; and underlined text contains the proposals of MFS-II.

The size of the wholesale discount will determine whether entry occurs by resale or by facilities-based competition. If resellers can obtain an excessive discount, facilities-based competitors will be forced to become resellers in order to survive. Moreover, high discounts will inhibit the creation of new local network investment by undermining the economic feasibility of investing in new networks.

Facilities-based competition will necessarily bring about construction of new networks for the local exchange market. In addition, facilities-based competition will provide the incentive necessary to ensure continual technological enhancement of the Illinois network.

Treating contribution as an avoided cost will not enhance competition in the local exchange market. Rather, doing so, would preserve or even enhance Ameritech's competitive position by dampening the incentive for facility-based entry.

Finally, as a policy matter, it would be inequitable to permit resellers and their end users to provide less contribution toward the Ameritech network than Ameritech's customers provide. Since both sets of consumers would utilize the network in nearly the same manner, both should pay equally in supporting the network. Considering contribution to be an avoided cost would provide pure resellers a competitive advantage over facilities-based providers. Consequently, the Commission must adopt the position that avoided costs do not include contribution.

~~Section 252 (d)(3) of the federal Act provides as follows:~~

~~(d) PRICING STANDARDS~~

~~. . .~~

~~(3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES. For the purposes of section 251 (c)(4), a State~~

> ~~commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.~~

~~In interpreting a specific provision of the federal Act, the Commission must look to the federal Act as a whole. We cannot interpret Section 252 of the federal Act in a vacuum. The purpose of Sections 251 and 252 of the federal Act is to facilitate competition in the local exchange market. Section 251 imposes a number of duties on all LECs, as well as specific duties on incumbent local exchange carriers. The duties placed on the LECs are immediate. The LECs must permit resale now, without delay, and the incumbent LECs must price resale as provided for in the federal Act. If the LECs comply with the requirements of the federal Act, the will, in return, be permitted to provider in-region long distance service. See Section 271 (c)(2)(B) Competitive checklist. Clearly, Congress has struck a compromise here between the competing interests. Incumbent LECs will lose some local market share and profits due to local competition; they, however, will have the opportunity to gain market share and profits in the long distance arena.~~

~~The Commission cannot interpret the federal Act in a way that is inconsistent with this compromise which is a central part of the federal Act. The problem with Ameritech's pricing proposal is that it is inconsistent with this compromise. Ameritech's wholesale pricing methodology places the incumbent LEC in a win-win position. Under Ameritech's pricing scheme, which only removes avoided costs from the retail price to reach a wholesale price, the incumbent LEC will not suffer a loss of any profits as it loses market share to resellers. The resellers, in effect, become an~~

~~outside sales force that will, if anything, generate an increase in gross sales for the incumbent LEC. With profits unaffected by loss of market share competition would not exert any competitive pressure on the incumbent LEC. This win-win situation — no loss in profits at the local level and new profits from long distance — is imply inconsistent with the intent of the federal Act. Section 252 (d) (3) of the federal Act must be interpreted on its own an in conjunction with the entire federal Act. In the context of the entire federal Act, this section allows the Commission the discretion to set a wholesale price in a manner that places some competitive pressure on the incumbent LECs as local competition increases, thereby creating effective competition.~~

~~Competitive pressure on both the incumbent LECs, as well as new entrants into the local exchange market, is the key to a properly established wholesale/retail market. Such pressure would be exerted in terms of price, cost, and service quality. This competitive pressure ensures that market participants will be as efficient as possible in order to service. Competition will benefit the consumer because the incumbent LECs and its competitors must constantly provide the best possible quality, price ans service in order to survive. If the federal Act as a whole intends to increase the local competition, then Section 252 (D) (3) must be interpreted in a manner that is consistent with this intent.~~

~~The federal Act grants State commissions such as this one the authority and discretion to properly set the wholesale price. We agree with Staff that the words "on the basis of," as they appear in Section 252 (d)(3) are not identical in meaning as the words, equal to." The Commission is of the opinion that Staff's methodology is consistent with the federal Act because it places competitive pressure on the incumbent LEC and it is based upon the concept of removing avoided costs from the etail price to reach a wholesale price.~~

~~The Commission also agrees with Staff that in removing the avoided retail costs in reaching a wholesale rate, a pro rata share of contribution pertaining to avoided retail functions must also be removed. This is because the incumbent LEC is no loner entitled to the entire amount of the contribution. The Commission views the incumber LEC's contribution as essentially a "mark-up" on the costs of the LEC. With the incumbent incurring fewer costs, there should be a corresponding reduction in contribution.~~

~~Unless the Commission takes this view, there can be no effective local resale competition. The Commission is persuaded by the arguments of AT&T and others that the margin of profit proposed by Ameritech will preclude their ability to earn a profit on resale of local service. Ameritech's argument that these parties did not make a showing of their costs is without merit. Any evidence that could have been proffered to this effect would have been too speculative and irrelevant.~~

~~Ameritech's argument that adoption of Staff's propose methodology will cause a significant drop in revenues is not a convincing argument to support its own methodology. In reality, the opposite is true. Missing from Ameritech's numbers is the reduction in profit that its own proposal will inflict as competition increases. We believe that the reason that this number is missing is because there would be no net loss in profit to the incumbent LEC under Ameritech's proposal. Adoption of Ameritech's proposal, where loss of market share would have no impact on profit, would only create the illusion of competition. This would be inconsistent with the intent of the federal Act and the policy of this Commission to promote competition.~~

~~Ameritech's's argument that the contribution of cost recovery and not profit is not a persuasive argument. The Commission understands that some of the contribution that Ameritech receives goes to cover expenses. The Commission is not, however, removing the recovery of all~~

~~contribution associates with the provision of wholesale services. In fact Staff's proposed methodology allows Ameritech a reasonable level of profit on its wholesale business. The loss in contribution occurs because the wholesale business is not and should not be as profitable as the retail business. This is because the incumbent LEC is providing less service as a wholesale provider.~~

~~This is also an issue of fairness. If a pro rata share of contribution is not included in the determination of wholesale rates, wholesale customers would pay a greater mark-up on incremental cost than would retail customers — making wholesale more profitable than retail. As stated above, the incumbent's wholesale business should not be as profitable as its retail.~~

~~Finally, Staff's proposal makes common sense. If the Commission were to adopt Ameritech's proposal, we would be essentially communicating to the resellers that they must survive in what the incumbents' costs are, because the profit that is built into the retail price must stay with the incumbent LEC. This result would be an unfair and contrary to the reasoned concepts of competition.~~

<u>Avoided costs</u> ~~Staff's methodology~~ should be <u>determined</u> ~~applied~~ on a "individual service element" basis rather than a "service family" basis. This approach avoids unnecessary and undesirable variation in the contribution margin between the corresponding wholesale and retain versions of the same service. This approach is also consistent with the federal Act, which describes the wholesale rate calculation methodology for "the telecommunications service requested . . ." Section 252 (d)(3).

The Commission, accordingly, rejects AT&T's interim pricing proposal. AT&T's use of a uniform discount rather than a service-by-service discount would encourage cherry picking of the most profitable services. In addition, AT&T's proposal structures the wholesale/resale market in a way that guarantees that resale is profitable. This would not be consistent with this Commission's policy regarding competition. Competition should be encouraged only to the extent that it is economically feasible.

With respect to AT&T and MCI's proposal to price wholesale services at LRSIC, the Commission is of the opinion that this methodology would not sufficiently compensate the incumbent LEC for the costs associated with offering wholesale services. Wholesale LRSIC, by definition, excludes the portion of common costs that would be incurred in the processes of providing wholesale services.

However, in an effort to ensure that Centel's wholesale discounts reflect avoided ~~avoidable~~ retailing costs on a service-by-service basis, Staff recommended that Centel's discounts (in percentage terms) be set equal to those discounts offered by Ameritech until the appropriate studies are competed. In support of this recommendation, Staff stated that its wholesale pricing plan was designed to ensure that discounts are reflective of avoided costs on a service-by-service basis and that this interim solution would be more consistent with its pricing structure than Centel's flat rate proposal.

In the event that Staff's interim pricing proposal is rejected, Staff states that Centel's FDC cost studies be modified before the flat rate discount is applied.

We await the results of the up-coming FCC rulemaking proceeding to determine whether further regulatory response is necessary.

~~Effective competition, which is the intent of the federal Act, requires Ameritech to lose some contribution when it loses a customer to a competitor. If this were not the case, Ameritech would feel no competitive pressure and, thus, would not have any incentive to provide higher quality~~

~~service. The Commission, therefore, adopts Staff's proposed pricing methodology for setting wholesale prices.~~

## II. FACILITIES-BASED COMPETITORS SHOULD NOT BE REQUIRED TO BEAR INCREMENTAL START-UP COSTS

MFS-II also takes exception to the Hearing Examiner's recommendation to the extent that it would require that incremental start-up costs incurred by the incumbent LEC in setting up the wholesale/resale market structure be recovered over time from *all* entrants into the market. HEPO at 29. The Hearing Examiner purports to adopt Staff's position on this issue. *Id.* However, a close reading of Staff's posthearing brief and reply brief reveals that Staff did not request that facilities-based entrants share in these costs.

Although Staff does argue that "[a]ll fixed costs incurred by the wholesale LEC in setting up the wholesale/resale market structure should be recovered in a competitively neutral manner," Staff Posthearing Brief at 54, Staff does not appear to argue that facilities-based competitors should share in those costs. On the contrary, the Staff simply states that its approach "will ensure that the initial resellers do not bear all of those costs and resellers entering the market at a later date would not be charged for such fixed cost." *Id.*

In the resale context, there is no basis in the 1996 Act to recover implementation costs from facilities-based entrants. Requiring facilities-based providers to pay for these costs would be entirely inconsistent with the 1996 Act's preference for facilities-based competition and would seriously hamper its development at this critical juncture. *See* MFS-II Ex. 1.1 (Montgomery) at 14-16.

> If all the added costs of either resale or additional element unbundling are spread broadly, it creates the incentive for a potential service

> provider to forgo making any capital investment of its own. In other words, the entity with a strategy that is least amenable to facilities based competition gains the most from a policy that allocates specific added costs related to resale or specialized element unbundling across all users of the incumbent's network.

*Id.* at 14-15 (emphasis in original). There is no authorization in the text of the 1996 Act for any competitively-neutral mechanism of distributing additional costs among all competitors, including facilities-based carriers. The fact that Section 251(e)(2) of the 1996 Act does create a distribution mechanism for the costs of number portability suggests that Congress's failure to authorize a similar mechanism for the additional costs of resale was deliberate. MFS-II Ex. 1.2 (Montgomery) at 4. Such costs should be borne by those who caused them.

The suggestion that facilities-based entrants should bear such costs also defies common sense. Spreading costs across all providers (facilities-based and resellers alike) would require facilities-based providers to pay both facilities and resale costs. Logically, if facilities-based providers must cover the costs of implementing resale, resellers should be required to defray the implementation costs of facilities-based entrants. Resellers have not helped to fund such costs. The Commission, consistent with the 1996 Act, should therefore reject outright any consideration of saddling facilities-based providers with the additional costs of resale.

Accordingly, paragraphs 1 and 2 on page 29 of the HEPO should be modified as follows:

The Commission adopts the ~~Staff's~~ position that all fixed costs incurred by the incumbent LEC in setting up the wholesale/resale market structure should be recovered from all carriers who either provide or purchase telecommunications service from the LEC pursuant to Section 251 (c)(4) of the 1996 Act (including Ameritech and Centel). ~~in a competitively neutral manner~~. This will ensure that the initial resellers do not bear all of those costs and resellers entering the market as a